IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT.

No. 14,559.

EMIL USIBELLI and ROSE P. USIBELLI,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decisions of the Tax Court of the United States.

BRIEF FOR AMICI CURIAE.

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The instant case represents the second occasion on which an Appellate Court has been faced with this important question:

Is a strip-miner of coal which mines pursuant to a contract giving him the exclusive right to extract coal from particular property, entitled to a share of the percentage depletion allowance where its gross income is dependent upon the extraction of the coal but not upon its ultimate sale price?

On the first occasion, the Court of Appeals for the Fourth Circuit answered the question in the affirmative. *Commissioner v. Gregory Run Coal Co.,* 212 F. 2d 52 (4th Cir., 1954), *cert. denied,* 348 U. S. 828.[1] The purpose of

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1. There are factual differences between the instant case and the *Gregory Run Coal Co.* case, *supra,* involving such matters as the provision in the contract limiting the amount of coal to be strip-mined and the Army's right to terminate the contract under certain circumstances. These factors are immaterial, as discussed in the latter portion of this brief.

amici curiae here is to urge the adoption by this Court of that same position and to present the fundamental question of such a strip-miner's right to depletion in its simplest and clearest form, free of all subsidiary factual problems.

I.

Our contention is threefold:

First: That Congress gave the right to percentage depletion to any taxpayer which derives its income from mining mineral property in which it owns an "economic interest" in the mineral in place;

Second: That a strip-miner which by contract has the right to extract coal from particular property and which is paid if, and only if, and when the coal is extracted, thereby assuming all the risks inherent in finding and getting the coal out of the ground has such an interest, even though it does not have legal or equitable title to the property; and

Third: That the question of whether a strip-miner has such an economic interest is not in any way affected by the market conditions of the coal business; in other words the disposition of the coal after its discovery, extraction and delivery pursuant to contract by the strip-miner is of no significance with regard to the existence in the first instance of an economic interest subject to depletion.

There is no difference of opinion on the first proposition. The Tax Court apparently agrees to the second as well, provided an additional factor of its own making exists, namely that the strip-miner's compensation be contingent upon the sale [2] of the coal.

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2. The use of the words "and sale" as part of the phrase "reliance upon extraction and sale" in depletion cases, apparently developed somewhat accidentally as a result of the fact that in so many instances, the payment involved was by lease or contract fixed in terms of the sale price by the operator (usually a lessee). Reference to sale in many of the cases has therefore been purely descriptive of the factual situation before the court. Prior to the Tax Court's preoccupation with the term, however, it was never used as a *sine qua non*

That this is so is readily apparent from an analysis of five recent Tax Court decisions on the point,[3] including the instant case. In *James Ruston,* 19 T. C. 284 (1952), the strip-miner derived his gross income from mining in the form of a percentage of the sales price of the coal. In the other four cases—the instant case, *B. H. Swaney & Sons, Inc.,* 12 T. M. C. 1371 (1953), *reversed on appeal sub nom., Commissioner v. Gregory Run Coal Co., supra, Morrisdale Coal Mining Co.,* 19 T. C. 208 (1952), and *J. E. Vincent,* 19 T. C. 501 (1952), *reversed on appeal sub nom., Commissioner v. Gregory Run Coal Co., supra*—the Tax Court found that the coal stripper was paid a fixed amount per ton of coal mined and delivered. In all other essential respects the relationship between the coal company and strip miner in these five cases was similar.

In *Ruston,* it was held that the strip-miner had an "economic interest" and was entitled to the percentage depletion allowance. In the other four cases, the Tax Court

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of the existence of an economic interest. Where the question of reliance on sale was actually in issue, it has been rejected as being without significance. *Eastern Coal Corporation v. Yoke,* 67 F. Supp. 166 (N. D. W. Va., 1946) ; *Commissioner v. Gregory Run Coal Co., supra;* see also Revenue Ruling 54-548, Internal Revenue Bulletin No. 48, November 29, 1954, where a lessor was paid a royalty measured by production only and no reference is made to reliance upon sale by the lessee.

The most recent example of a descriptive (but not limiting) use of the phrase "extraction and sale" is *Commissioner v. Southwest Exploration Co.,* — F. 2d — (9th Cir., 1955), *affirming per curiam,* 18 T. C. 961. The question there was whether taxpayer had to exclude from its gross income from the production of oil the percentage of its net profits which it was required to pay under the lease to other parties. As indicated, the phrase "extraction and sale" was the usual descriptive phrase to use in setting forth the facts before the court. It had no other significance.

3. Despite the *Gregory* decision, the Tax Court apparently considers its distinction based on payment out of or contingent on sale, to be firmly established. Its more recent decisions tend simply to say that the facts fall within one group or another depending upon reliance upon sale. This superficial analysis was the basis of the decision in the instant case. See also *The Mammoth Coal Company,* 22 T. C. No. 73 (1954) ; *Winfield Mining and Contracting Company,* 13 T. C. M. 571 (1954).

reached a contrary conclusion. In denying the deduction to the strip-miner the court used this language in the *Morrisdale* case:

> "The contractors [strip-miners] assumed no risk as to the market price, they received no payment in coal, and they had no right to sell any coal to other parties." 19 T. C. at 217

Likewise in the instant case in denying the depletion allowance to the strip-miner the Tax Court said:

> "The record does not show that his payment depended upon any sales or market prices of the coal but indicates that they depended upon mining costs." (R. 47)

Thus the existence or non-existence of an "economic interest" in the coal in place was made to turn on whether the strip-miner's income was based upon a percentage of the sale price, on a question involving the status of the coal market at a particular time, on a question of salesmanship which has nothing whatsoever to do with mining. This is a condition of the Tax Court's own invention—a condition the only other Appellate Court to consider the question held to be wholly erroneous. *Commissioner v. Gregory Run Coal Co., supra.* The existence in the first instance of an economic interest in coal in place should in no way depend upon whether the strip-miner's economic interest in the coal continues *after* it has been discovered and mined and turned over to the coal company for sale.

Thus as stated above, the Tax Court has added its own condition to the depletion allowance—that the strip-miner assume the risk as to the market price by having his compensation depend on the sales price of the coal. But the condition of the coal market is no more significant than the condition of the automobile market or the furniture market and so on. Yet that factor—whether or not the strip-miner's income is contingent upon the actual sales price of the coal on the coal market—is the basic premise to which

the Tax Court has pegged the strip-miner's right to depletion.

It is our position that this reliance upon a risk which has nothing to do with mining is erroneous. We believe that it is an error of substance which flows from a basic misconception of the fundamental nature and purpose of percentage depletion. That allowance is the outgrowth of a history which is of obvious significance to a proper understanding of its legislative purpose. To the extent relevant here, that history can be summarized briefly.

The first statutory provision took the form of cost depletion. Because natural resources inevitably are exhausted, the owner of those resources was allowed to recover his cost (or March 1, 1913 value, if higher than cost). This allowance involved but two elements: ownership, and proof of cost or March 1, 1913 value. See *United States v. Ludey*, 274 U. S. 295 (1927). This allowance was extended to a lessee by judicial decision in *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364 (1925), dealing with the Revenue Act of 1916. The Revenue Act of 1918 (Section 214) specifically provided for an equitable division of the cost depletion allowance between lessor and lessee.

That same Act contained also the first step away from the conventional concept of depletion as a method of recovering cost. The new approach resulted from the legislative desire to encourage operations designed to get the coal above the ground. By way of inducement and reward for the exploration of mineral deposits discovered after acquisition of the property, the basis for determining depletion was the value of those newly discovered resources. "To stimulate prospecting and exploration", Sections 214(a)(10) and 234(a)(9) provided for a limited tax on the sale of certain mineral producing properties and for depletion based on discovery value. Senate Report No. 619, 65th Cong., 3d Sess., 1939-1, Part 2, Cum. Bull. pp. 121, 122. As Senator Reed stated in the debates on the Revenue Act of 1926:

"If we were to calculate the depletion at some fixed percentage of the cost of the property that would not occur. But ever since early war days Congress has followed the policy of allowing what they call discovery value for both oil and gas wells and for minerals. It is perfectly obvious that if I buy an acre of land in the Rocky Mountains and pay $10 for it, and then, by hard work, discover a rich deposit of gold in it, the calculation of my depletion on the original $10 basis would not allow me any adequate return for my real capital. So, in allowing what is called discovery value, Congress and the bureau have tried to get at the real but the unknown value of the property owned by the taxpayer. . . ." See 67 Cong. Rec. 3561-78.

The full significance of the true purpose of the allowance is reflected also in the statement made in reporting the discovery provision in the Revenue Act of 1926:

"Under the existing law, discovery depletion is allowable to one who brings in a well upon property proven at the time the well is brought in, if at the time it was purchased by the taxpayer it was not proven. Obviously the benefits of discovery depletion, the purpose of which was to encourage the wildcatter or pioneer, should be limited to those who make an actual discovery." See 69th Cong., 1st Sess. H. R. Rep. No. 1, p. 6; 1939-1 (Part 2) Cum. Bull. 319.

But this new concept, unrelated to cost, involved burdensome administrative difficulties in proving the value of the newly discovered mineral deposits. Accordingly, retaining the fundamental idea that cost was not an integral part of any depletion allowance, Congress conceived of the idea of percentage depletion. This first appeared in the Revenue Act of 1926 as to income from oil and gas wells and was extended to coal mining in 1932. As an inducement to the miner, percentage depletion could be taken so long as gross income was derived from the mining operation, despite the fact that the allowance resulted in a deduc-

tion many times the amount originally invested or the mine's discovery value at the time the mining operation began. This fundamental aspect of percentage depletion was restated only as recently as 1951 by Senator Humphrey:

> "Under the present law, the amount of percentage depletion bears no relation to the capital cost of the property, but only to the income. . . . [S]ince the percentage depletion allowances are unrelated to the captital the tax-free recoveries through percentage depletion are often many times the original investment." 97 Cong. Rec. 12307.

Finally, Congress showed further need to induce mining by allowing percentage depletion without regard to whether the mine represented a new discovery. See 4 Mertens' Law of Federal Income Taxation, § 24.31a (1954).

This brief analysis of legislative history discloses two things:

First, that percentage depletion has nothing whatsoever to do with recovery of cost or any other investment in the ordinary sense to acquire the particular natural resource involved. Thus when the cases speak about the taxpayer being permitted to "recover" his "investment" or "capital", it is obvious that they are referring not to a cost or capital outlay made by the taxpayer to acquire the right to receive the coal, but rather what the taxpayer acquired by signing the binding contract which conferred upon him the exclusive right to extract the coal in place. See *e.g., James Ruston, supra.*

Second, that the purpose behind percentage depletion is to encourage coal mining by providing a special tax benefit to those persons who actually extract the coal and take the risks inherent in mining (not the risks of the market). This is accomplished by allowing a deduction from the taxpayer's gross income derived from mining.

The significance—or more accurately the lack of any significance—of the strip-miner's "gross income from min-

ing'' being dependent upon the sales price is conclusively demonstrated by the statutory definition of ''gross income from mining.'' Section 114(b)(4)(B) of the Internal Revenue Code (1939), provides that mining is considered to include, ''not merely the extraction of the ores or minerals from the ground'' but also the subsequent ordinary treatment processes necessary to obtain the commercially marketable product as well as certain transportation costs. No reference whatsoever, however, is made to the sale of the mineral. The inclusion of the subsequent processes, of course, does not mean that a taxpayer who assumes the risk inherent in the basic job—i.e., extraction of the ore—is denied percentage depletion because he is not *also* involved in the fringe and later processes which are also given the benefit of percentage depletion. Rather these subsequent processes are specifically included so as to make it clear that the gross income upon which the deduction is based is not limited solely to that derived from the extraction.

The vice in the Tax Court's position is that not only does it tack on the selling process, found nowhere in the Code, but it makes that process a *sine qua non* of enjoyment of percentage depletion for those taxpayers who perform extraction *and* some or all of the other activities specifically set forth in the statute.

The same point is further illustrated by the decision in *Eastern Coal Corporation v. Yoke,* 67 F. Supp. 166 (N. D. W. Va., 1946). In that decision, which has been cited many times, the court held that a strip-miner who under contract extracted the coal and was compensated by a fixed sum per ton of coal had the ''economic interest'' entitling it to a deduction for percentage depletion from the compensation so received.

The court commented further that it had not found

> ''a single case among the many cases involving percentage depletion where the actual producer has been denied percentage depletion with respect to his interest in the proceeds of the mineral produced.'' (At p. 177)

Respondent in March 1950 issued a General Counsel Memorandum, G. C. M. 26290, 1950-1 Cum. Bull. 42, dealing with a strip-miner's right to depletion. Much reliance was placed upon *Eastern Coal Corporation v. Yoke, supra,* which was cited with approval in this manner:

> "It is also to be noted that in *Eastern Coal Corporation v. Yoke,* supra, the position was taken by the court that the right of a contractor to a specified amount per ton of mineral produced may constitute a right to share in production which marks ownership of a depletable economic interest in the mineral in place."

We believe the Tax Court clearly recognized that the percentage depletion allowance was intended as a reward to the miner who takes the risks inherent in mining. It failed to realize, however, that the risk of the market is obviously not one peculiar to the extractive industries, but is existent in every commercial activity; and that the assumption of this market risk is not one of the risks which Congress intended to reward.

This was the basis of decision in *Commissioner v. Gregory Run Coal Co., supra,* which, as already stated, is the only Appellate Court decision on the question. The Court there specifically rejected the argument that the existence of the strip-miner's economic interest (and thus his right to participate in depletion) depended upon his assuming in some way the risk of the market. Instead the Court found an economic interest in and awarded the right to participate in depletion to a strip-miner who was paid on a fixed sum-per-ton basis. Relying upon *Eastern Coal Corporation v. Yoke, supra,* the Court said:

> *"We think, however, that in the pending case the rights of the producers were completely dependent upon the extraction of the salable product and that consequently they were entitled to share in the benefits of*

> *the statute which were designed to give compensation to persons interested in the production of a wasting asset."* (p. 61) (italics supplied)

In other words, the right to depletion exists whenever the taxpayer's income is dependent upon the risks inherent in finding and extracting the coal, not those risks inherent in selling it.

The legislative history, the express language of the Code, the court decisions, such as *Commissioner v. Gregory Run Coal Co., supra,* and *Eastern Coal Corporation v. Yoke, supra,* the soundness of the latter being expressly recognized by Respondent, all conclusively show the error of the Tax Court in making the existence of an economic interest and the allowance for percentage depletion turn on whether or not the strip-miner derives and measures its compensation from the ultimate sale price or profit derived from the sale of the coal.

The sole question is whether a strip-miner, who in a particular case has by contract acquired an exclusive right to extract coal on a particular property, is the taxpayer whom Congress intended to benefit for assuming the risks inherent in the mining operations. Strip-miners just like any other coal producers, or any drillers or prospectors for natural resources, run the risks inherent in the operation. It is they who bring in their own expensive mining equipment and employees; who build roads and other improvements required to proceed with the mining; who pay taxes and all other obligations involved. It is the strip-miner, who after assuming all these risks and burdens runs the basic risks that the coal field is barren or that the coal is not merchantable. *These are the risks peculiar to mining and to which the depletion allowance was directed.* Once the coal is above the ground, the risks are those of sale, a problem inherent in all businesses and, therefore, not warranting a special reward.

II.

The previous discussion demonstrates the complete lack of significance of reliance upon sale in connection with the determination of the existence of an economic interest. The purpose of this portion of our brief is to establish that the right to cancel or limit the tonnage to be mined is equally insignificant.

The Tax Court felt otherwise. It said:

> "[The stripper] . . . could mine only limited quantities of coal and the amount could be reduced by the Government. The contracts could be terminated by the Government under certain circumstances." (R. 47)

It is our position that these facts are completely irrelevant to the only question here involved: does the strip miner have an economic interest? As indicated above (page 2) it is agreed, even by the Tax Court, that such an interest may exist in the case of "a strip miner which by contract has the right to extract coal from particular property and which is paid if and only if and when the coal is extracted, thereby assuming all the risks inherent in finding and getting the coal out of the ground . . . even though it does not have legal or equitable title to the property." [4]

It is our position that the existence of this economic interest is not affected by such quantitative factors as the amount of coal to be mined and the period of time during which the stripper is allowed to continue his operations. Once the economic interest is determined to exist, then the question (not here involved) of the amount of the depletion allowance becomes relevant. Even in that regard, however, such question as the existence of a right of termination is relevant only if the right is actually exercised and then only because it may affect gross income from mining which thus in turn affects the amount of depletion allowance. For, of course, the smaller the tonnage mined the lower the

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4. Leaving aside the dispute between the Tax Court and the Court of Appeals for the Fourth Circuit as to the significance of reliance on sale.

income from mining and thus the smaller the deduction for depletion. But none of that has anything to do with the more fundamental question of the *existence* in the first instance of an economic interest, without which there is no right to depletion. It is only after that right has been established by virtue of finding that an economic interest exists, that it becomes relevant to look at amounts and computations, and even then only for the purpose of determining the amount of the depletion deduction—and that is not here in dispute. These quantitative considerations are of no greater moment here in relation to that basic question than such things as the cost and life of an asset or renewable feature of a lease are in relation to the existence of the *right* to (as opposed to the amount of) depreciation. Obviously, the lower the cost and the longer the life of an asset, the smaller the amount of the annual deduction for depreciation. But the *right* to any deduction at all exists even if the asset cost $10.00 and has a life of ten years. So here: the cancellation of a contract or the reduction of the tonnage to be mined may reduce the amount of the income from mining and therefore necessarily the amount of the deduction for depletion. *But these quantitative considerations have no other relevance*[5] They cannot affect the basic, initial question of whether there is an economic interest to start with.

The irrefutable soundness of this conclusion is demonstrated by the difficulties created by any effort to determine the point at which these limitations of quantity are effective to prevent the existence of an economic interest. In G. C. M. 26290, *supra,* the Commissioner decided that if a stripping contract cannot be terminated within a period of less than one year, then ordinarily the stripper has an eco-

5. Except in the extreme case where facts such as these, in combination with all the other facts in the case, require the finding of fact that the stripper is no more than an employee. In such event, the income from mining is the income of the employer; the employee simply receives compensation for services rendered. Cf. *Hughes,* 14 T. C. M. 172 (1955).

nomic interest because he has enough time to mine "*a substantial* portion of the mineral deposit" (italics added). What is "substantial"? Suppose the property involved is sufficiently large as to require fifteen years to complete its stripping and that unusual amounts of overburden make it clear that disproportionately small amounts of coal will be mined in the first several years? Is less than 1/15 of the coal involved "substantial"? Furthermore and of more fundamental importance, is it not entirely consistent with the whole history and purpose of percentage depletion—and in fact do not that history and purpose require the conclusion—that the stripper acquires an economic interest upon the signing of such a contract, that the only significance of cancellation and the like is in relation to the monetary tax result which flows from the existence of that interest in the form of the deduction for depletion.

Continuing with the GCM, it provides that where the stripping contract is terminated on less than one year's notice, then all the facts must be considered in determining whether that power to terminate prevents the creation of the economic interest in the first instance. Among the facts listed are the size of the deposit and the estimated time required for its extraction. Thus, if cancellation requires notice of one year and a day, the presumption is that the stripper has an economic interest; but if notice need be for only 364 days, then it depends on whether the stripper has enough time to qualify his rights as an economic interest. In other words, whereas in the latter case, the presumption might be that 1/15 is not substantial, the reverse is true in the former case; yet in each case both strippers perform exactly the same function in the same maner under the identical contract giving them identical rights and obligations, the only difference being two days in the notice period. There is no sound basis for this distinction insofar as the fundamental issue of the existence of an economic interest is concerned. We submit that that issue is not affected by the limits on the amount of coal to be mined.

CONCLUSION.

We contend that a strip miner with the right by contract to mine coal from particular property, assuming the risks inherent in mining in relying upon the discovery and extraction of coal from the mine as the source of his income, is engaged in the precise mining activity which Congress intended to encourage by the percentage allowance. We contend that that strip miner is assuming the very risk for which depletion allowance was created as a reward, the risks which establish that he has an economic interest in the coal in place, as the various courts have defined that term. We contend that no other factor is relevant in connection with that fundamental issue; that risks involved in selling coal and in being limited in the amount to be mined, whether directly in the form of tonnage restriction, or indirectly in the form of cancellation on short notice, are completely without significance.

The strip-mining companies are an important segment of the coal mining industry and such companies assume all the risks inherent in removing near-surface coal. As Respondent stated in G. C. M. 26290:

> "In the mountainous coal fields of the East there are few large areas which can be mined by removing the overburden, and the owner or lessee of the property does not ordinarily buy the necessary stripping equipment. Accordingly, in the case of small tracts of coal land from which the mineral cannot be economically removed by underground mining, as well as in situations in which a fringe of coal near the surface cannot be satisfactorily extracted by underground methods, the contractor who owns stripping equipment has solved a problem of the industry."

The Tax Court erred, therefore, in the instant case in denying depletion to the strip miner who devoted his equipment, time and money to digging for the coal, who incurred all the risks inherent in strip-mining, and who is the one

on whom users of coal must depend to get the near-surface coal above the ground. The Tax Court erred, therefore, in refusing to follow the decision of the Court of Appeals for the Fourth Circuit in *Commissioner v. Gregory Run Coal Co., supra,* that reliance upon sale of that coal has nothing to do with the question. The Tax Court erred, therefore, in adding still another irrelevant fact, namely, limits on the amount of coal to be produced.

Respectfully submitted,

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